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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of May 7th to May 14th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
M3 Supply	**May 14**	Apr	**16.9%**	16.6%	17.6%	Annual growth rate negatively affected by base effects. Lower valuation of currency deposits stems from firmer zloty. Lower outflow from mutual funds.
CPI Inflation	**May 14**	Apr	**3.8%**	3.8%	3.6%	Higher food prices and fuels are the main drivers of the CPI inflation. Core categories rather unaffected leading inflation excluding food and fuels to 2.4% after 2.5% a month ago (to be published May 21).

In Focus / Macroeconomics

A blow from the European Commission

European Commission revised the Polish GDP growth forecast from +2.0% to -1.4% for 2009 this week. Such a sharp revision naturally triggered the downgrade of all projections for Polish fiscal indicators. So, the European Commission revised the general government to 6.6% of GDP in 2009 and 7.3% in 2010 up from 3.9% recorded in 2008. These forecasts back the European Commission's recommendation to impose the excessive deficit procedure on Poland – pretty an obstacle for the prompt entry of the ERM2 mechanism.

As one should have expected dramatic revision of forecasts triggered quite an allergic reaction of Polish government (the government forecasts GDP to growth by 0.5-1.0% this year and fiscal deficit below 4.6% of GDP). Government's arguments, which include some doubtful positive effects of past tax reductions on consumption and higher but not recognized by EC infrastructure investment, not very convincing, though.

Turning to our economic forecasts, we acknowledge that many sectors of the Polish economy recorded a cyclical pronounced overinvesting in 2008 and deteriorating labor market conditions will force households to cut on consumption. Thus, we forecast 0% GDP growth this year (with the risk skewed toward negative reading). The forecast accounts already for positive (almost +1 pctg point) contribution of net exports and improving prospects for the global economy in the second half of this year. We expect the recovery of the Polish economy to be led by the supply side, industry in particular, benefiting from the improved international competitiveness. Due to the aforementioned overinvesting, clogged credit market and weakening consumption (households revise the expectations of their future income and there are some signs of rising savings rate) the domestic demand is very unlikely to fully recover before 2010. The consequence of which will be a pronounced shortage of budget revenues (about 30bn PLN this year) and rising fiscal deficits (much above 4.5% of GDP in 2009). Due to political calendar (European parliament elections this year, Presidential elections next year, parliamentary elections in 2011 and the need to secure the so-called social capital) overshooting fiscal convergence criteria and further postponing the euro adoption are getting more and more likely.

Ministry of Finance puts April's inflation At 3.9%

The forecast issued on Monday did not surprise the market much, as government various officials talked the issue a some days earlier suggesting CPI would be still outside the tolerance band. The reason behind the inflation pick-up lies mainly in food prices which grew by more than 1% in monthly terms. Such a persevere growth of food prices has to do with some structural change. Higher exchange rate reduced imports and boosted exports. Higher exports revenue discouraged firms to sell on the domestic market – the correction towards equilibrium must have worked through higher domestic prices – and this is exactly what has been happening. It is possible that growth rate of food prices will stay elevated for some time, negatively affecting inflation.

In case of benign food prices, next month inflation may come closer to the target range (say 3.6-3.7 is possible). Positive boost might have been given by the reduction of gas tariffs, but they still have not been finally accepted by the regulator (there is the risk though that some of the price drops may still occur in May, but they should be officially accepted till the middle of the month).

Apart from temporary deviations in case of food prices, the trend in the CPI remains negatively sloped. Sharp increase of spare capacities and deteriorating labor market are likely to drag inflation downwards in coming months. There are only minor spillovers from broad consumer basked into the core categories. Core inflation is likely to fall in April to 2.4% after 2.5% recorded a month ago.

No improvement in Polish PMI

Contrary to the improvement recorded in April's standard business tendency indicators (those prepared by the Statistical Office) and sizeable green shoots abroad, PMI slipped a bit to 42.1pts versus 42.2pts recorded in previous month.

The commentary delivered after the publication suggests there had been a downward correction in new orders indicator which; the good news is ongoing reduction of stocks, compared with sluggish buying activity. As for the employment, the pace of layoffs was sustained as firms need to adjust current production to the inflow of orders. On the nominal field manufacturers experienced firmer tendency to lower the price of final goods owing to mounting deficiencies in demand.

Summing up, PMI reading confirms that extraordinary results of industrial output were a typical technical correction in a still negative trend. In the next months the growth rate of industrial output is likely to return to double digit falls, especially taking into account the highly accurate business tendency survey conducted quarterly by the central bank (which is just awful showing only signs of deterioration). It leaves only one question on the extent of the surprise when the MPC realizes the hold-up in rates bases on shaky assumptions and its only (but highly unwelcomed) result was an elevated WIBOR rate.

MID-TERM FORECATS

Indicator	2006	2007	2008	2009	2010
GDP y/y (%)	6.1	6.5	4.8	0.0	2.0
Inflation rate (%, average)	1.0	2.4	4.3	3.0	2.0
Current account (% of GDP, average)	-2.1	-4.5	-5.3	-3	-2.5
Unemployment rate (end-of-year)	14.9	11.4	9.5	13.5	13.9
NBP repo rate (end-of-year)	4.00	5.00	5.00	3.25	4.00

Indicator	2008		2009			
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	4.7	2.9	1.0	-1.0	-1.5	0.4
Inflation rate (%, average)	4.7	3.8	3.2	3.1	2.5	2.4
NBP repo rate (end-of-quarter)	6.00	5.00	3.75	3.50	3.25	3.25

Bold denotes chages from the last release with arrows showing the direction of chages

Fixed Income

Local data very negative.

Last week market got some quite negative news. First bit came from Ministry of Finance CPI forecast for April standing at 3.9% way above market expectations. Second came from European Commission showing rather unfavorable GDP dynamics accompanied with imbalance growing in public sector. Rates pushed up some 15 bp across the curve in parallel shift, bonds didn't suffered that much even after another well bid switch auction. We saw good demand for ASW, with floating rate bonds finally getting better bid. We still like holding ASW in 2y bonds but we reduced our holdings to 25% of limit. The most important thing for us currently will be Friday's OMO operation. For the past week WIBOR rates move up significantly, mostly due to fact that NBP is not leaving any extra liquidity on the market. If that policy is maintained we see risk of very sticky WIBOR, they can move down very little, even after the rate cuts. Furthermore short bonds, which were the best performers on the market for the past 2 months can suffer significantly. Over all we see little opportunities at moment which guarantee returns comparable to ones that we saw in the beginning of the year. We are looking for range to be formed in rates, but our preference is rather for sell off in bonds or rates higher, but timing wise next week can be rather calm. Once again we recommend defensive strategy, we also like 5y10y steeper.

RECOMMENDATION:

Reduce ASW holdings, stay pay in 5y10y steepener.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.142%	12/9/2008
26 Week T-bills	-	-	4.456%	5/4/2009
52 Week T-bills	5/11/2009	-	5.041%	5/4/2009
2Y T-bond OK0711	5/13/2009	-	5.615%	4/1/2009
5Y T-bond PS0414	6/3/2009	-	6.039%	4/1/2009
10Y T-bond DS1019	5/20/2009	-	6.224%	4/8/2009
20Y T-bond WS0429	5/20/2009	-	5.369%	1/14/2009

Money Market

Shortest rates back to the main rate level

Next rates cut likely in June

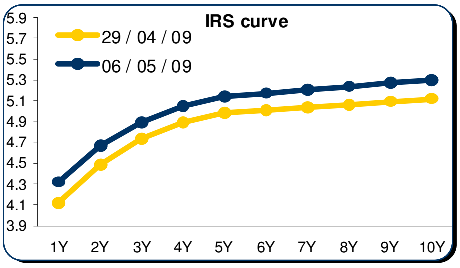
Shortest rates back to the main rate level. Open market operations are again bigger and aiming at squaring the reserve amount in the system. We can not say weather it is permanent change or the central bank will again boosting liquidity. For money market and for its derivatives their decision remains the biggest risk factor. It is not clear at all what are their goals, therefore trying to guess does not make any sense as of today. This odd situation hugely affected the market. Turnover is negligible plus the cash market focuses only on daily liquidity. The OIS curve went up by around 50 bps, all liquidity driven. Spreads are wide and reluctance to trade dominated this uncertain situation.

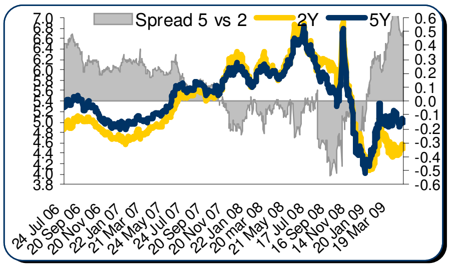
No rates cut expectations for May. Consensus is that another cut very likely in June when the MPC will have the new CPI projection.

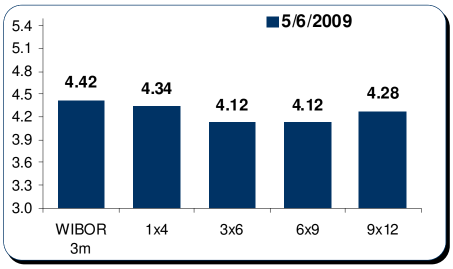
RECOMMENDATION:

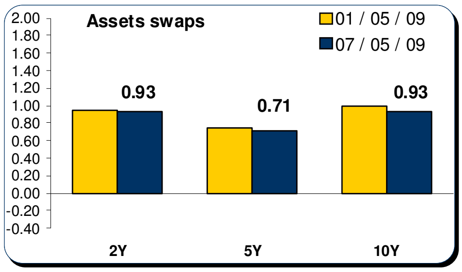
Offer long OISs at current levels.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty bit stronger

This week zloty has opened at 4.3700 and has been traded on stronger side to Thursday's low 4.2950. Main driver was once again good global sentiment what made all CE3 currencies performing very well.

Implied volatility untouched

Despite zloty strengthening, vols are traded at pretty same levels, 1M's is at 22.5 and 1Y's at 18.25.

RECOMMENDATION:

SPOT

Short EURPLN

Main supports / resistances:
EUR/PLN: 4.2200 / 4.6000
USD/PLN: 3.1000 / 3.5000

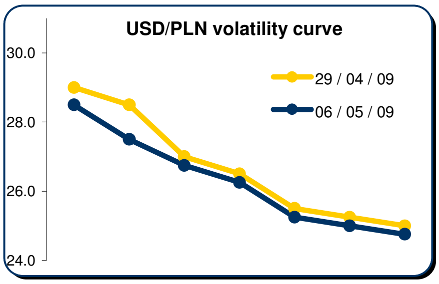
Short gamma

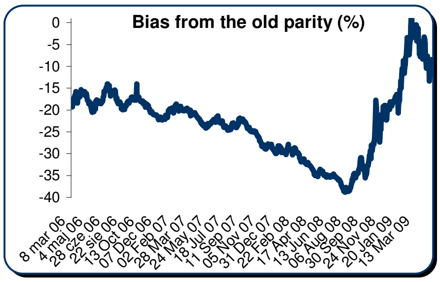
We leave 4.22 as target for this move, as we know that good global sentiment is prior element of this puzzle than possible, future budget financing problems. We expect problem will back to play if risk appetite will decrease.

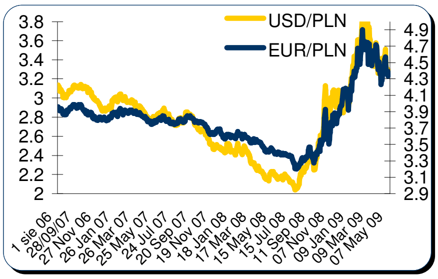
OPTIONS

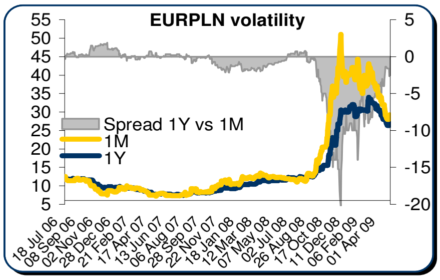
Vols looks a bit offered here, so we suggest wait for higher levels to entry short vega. Selling gamma, however, looks as good idea.
For hedging we suggest buying KO options as it is cheaper due to barrier pricing on high volatility market.
Exporters may have some benefits from selling Risk Reversals as it is nearly highs (4.5 vols favour call).

FX CHARTS









MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
29/04/09	4.18%	4.29%	4.26%	4.30%	4.44%	4.48%
30/04/09	4.18%	4.30%	4.36%	6.49%	4.46%	6.59%
04/05/09	4.30%	4.32%	4.36%	4.32%	4.46%	4.51%
05/05/09	4.25%	4.38%	4.40%	4.38%	4.70%	4.59%
06/05/09	4.35%	4.42%	4.35%	4.41%	4.55%	4.63%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
29/04/09	4.17%	4.03%	4.07%	4.25%	4.19%
30/04/09	4.15%	3.99%	4.02%	4.19%	4.16%
04/05/09	4.14%	3.94%	3.97%	4.13%	4.13%
05/05/09	4.20%	3.98%	3.99%	4.13%	4.18%
06/05/09	4.20%	3.97%	4.00%	4.17%	4.18%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		10Y	
	WIBOR	TB	IRS	OK0709	IRS	PS0511	IRS	DS1017
29/04/09	4.48%	4.90%	4.48%	5.12%	4.98%	5.65%	5.12%	5.99%
30/04/09	6.59%	4.89%	4.54%	5.48%	5.03%	5.78%	5.19%	6.18%
04/05/09	4.51%	4.93%	4.59%	5.55%	5.09%	5.81%	5.19%	6.21%
05/05/09	4.59%	4.95%	4.59%	5.52%	5.08%	5.82%	5.22%	6.19%
06/05/09	4.63%	4.98%	4.67%	5.60%	5.14%	5.85%	5.30%	6.23%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/05/04	09/05/04	95.150	5.04%	2700	3231	1328
OK0711	09/04/01	11/07/26	88.147	5.62%	2000	4384	2144
PS0414	09/04/01	14/04/26	98.748	6.04%	1500	2427	1514
DS1017	09/04/08	19/10/25	94.460	6.22%	2500	4846	1820

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
29/04/09	28.50	26.50	25.50	25.00	4.00	5.50	1.25	1.25
30/04/09	28.25	26.25	25.25	24.75	3.75	5.25	1.25	1.25
04/05/09	28.25	26.25	25.25	24.75	3.75	5.25	1.25	1.25
05/05/09	28.25	26.25	25.25	24.75	3.75	5.25	1.25	1.25
06/05/09	27.50	26.25	25.25	24.75	3.75	5.25	1.25	1.25

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
29/04/09	3.3680	4.4498	-11.85%
30/04/09	3.2859	4.3838	-11.83%
04/05/09	3.3049	4.3913	-9.99%
05/05/09	3.2548	4.3513	-8.49%
06/05/09	3.2985	4.3933	-8.57%

Note: parity on 11/04/00 – USD= 4.3806, EUR=4.2196, basket share 50:50

Mid-market volatility of vanilla option strategies

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